Controls Need to Be Strengthened Over the Internal Revenue Service's Taxable Travel Reporting

June 2002

Reference Number: 2002-10-107

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 19, 2002

MEMORANDUM FOR CHIEF FINANCIAL OFFICER

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Controls Need to Be Strengthened Over the Internal Revenue Service's Taxable Travel Reporting (Audit # 200110027)

This report presents the results of our review of the Internal Revenue Service's (IRS) taxable travel reporting. The overall objective of this review was to determine whether the IRS had developed and implemented effective procedures and system corrections necessary to address long-term taxable travel reporting requirements. This audit was performed at the request of the IRS to evaluate the final procedures and system corrections that the Chief Financial Officer (CFO) developed to address the long-term taxable travel issue on the Travel Reimbursement Accounting System (TRAS).

In summary, we found that the IRS has taken positive steps to implement processes to address the reporting requirements of long-term taxable travel transactions. Further, our tests of a judgmentally selected sample of travel transactions and adjustments showed that Federal, Medicare, and Federal Insurance Contribution Act (FICA) taxes were accurately calculated. However, we identified deficiencies in manually recording long-term taxable travel transactions, withholding state income taxes on adjustment entries, requiring supervisory approval for adjustment entries, and accurately classifying travel vouchers.

Management's Response: IRS management agreed with three of the recommendations contained in the report. They are in the process of evaluating a fourth recommendation and will make a decision before the end of this fiscal year on whether they will change current policy. Corrective actions taken or to be taken include updating the TRAS to perform the long-term taxable travel withholding process, including systemic controls to ensure the computations and amounts are correct; providing oral direction to reject requests for long-term taxable travel adjustments that do not reflect supervisory approval; issuing policies and procedures for long-term taxable travel and making them available on the CFO travel and relocation website; and issuing a memorandum to all

Heads of Office re-emphasizing the policies and procedures associated with the classification of long-term taxable travel situations. Management's complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Headquarter Operations and Exempt Organization Programs), at (202) 622-8500.

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Background

When Internal Revenue Service (IRS) employees incur and are reimbursed for long-term travel to temporary duty locations, the reimbursement, when meeting certain criteria, must be included as ordinary income and is taxable. Long-term taxable travel is typically described as either:

- Travel away from the employee's home for more than one year or for which there is a reasonable expectation that such travel will last for more than one year;[1] or
- Daily travel between the employee's residence and a work location that is for more than one year or for which there is a reasonable expectation that such travel will last for more than one year.[2]

When a long-term travel situation is identified, a Form 12654, *Authorization for Long-Term Taxable Travel* should be prepared by the employee and approved by the employee's supervisor. The taxable situation results in the IRS withholding appropriate taxes from the employee's travel reimbursement.

The IRS pays an Income Tax Reimbursement Allowance (ITRA) to employees incurring an additional income tax liability as a result of long-term travel reimbursements. The ITRA is designed to reimburse employees for Federal, state, and local income taxes. It does not reimburse employees for Federal Insurance Contribution Act (FICA)[3] or Medicare taxes. The ITRA is authorized by the General Services Administration in the Federal Travel Regulations.

This audit was performed at the request of the IRS to evaluate the final procedures and system corrections that the Chief Financial Officer (CFO) developed to address the long-term taxable travel issue on the Travel Reimbursement Accounting System (TRAS).

Our review was conducted at the IRS' National Headquarters in Washington DC; the Administrative

[1] Revenue Ruling #93-86 26 CFR 1.162-2; *Travel Expenses*.
[2] Revenue Ruling #99-7 CFR 1.162-2; *Travel Expenses*.
[3] FICA taxes are only withheld for employees that are covered by the Federal Employee Retirement System.

Accounting Division in Bethesda, MD; and, the Beckley Finance Center (BFC) in Beckley, WV during the period May through October 2001. The audit was conducted in accordance with *Government Auditing Standards.* Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Positive Steps Have Been Taken to Implement Processes Addressing Long-Term Taxable Travel Recording

The IRS has issued various memoranda and alerts announcing the long-term taxable travel rules. Implementation and processing personnel were generally aware of long-term taxable travel requirements. The IRS has also updated its TRAS to identify long-term taxable travel vouchers for manual withholding purposes.

Employees generally prepare and submit travel vouchers through the IRS' TRAS. After approval by the employee's supervisor, the travel voucher is up-loaded to the IRS' Automated Financial System (AFS) for processing. Long-term taxable travel reimbursements are automatically suspended by the AFS for manual calculation of taxes to be withheld. Amounts are withheld for Federal and state income, Medicare, and FICA taxes. The IRS' BFC performs these manual withholding calculations. The calculated amounts are netted from the employee's travel cost reimbursement prior to disbursement. In addition, the BFC also processes adjustments that are necessary to correct prior withholding or non-withholding of taxes.

During calendar year (CY) 2000, the IRS withheld in excess of $1 million in Federal income taxes, $107,000 in state income taxes, $74,000 in FICA taxes, and $54,000 in Medicare taxes associated with long-term taxable travel reimbursements for 1,702 IRS employees.

Federal Income, Medicare, and Federal Insurance Contribution Act Taxes Were Accurately Calculated

Our review of judgmentally selected samples[4] of employee long-term taxable travel vouchers processed during CY 2000 showed that Federal income, Medicare, and FICA taxes were accurately calculated. The sample included 215 travel vouchers with taxable income of approximately $522,600. These vouchers showed approximately $146,300

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[4] See Appendix I for a description of the various samples and population.

($522,600 at the rate of 28 percent) in Federal income taxes withheld, $7,000 ($113,000 at the rate of 6.2 percent) in FICA taxes withheld, and $7,600 ($522,600 at the rate of 1.45 percent) in Medicare taxes withheld.

However, as presented later in this report, we believe that some of the taxes withheld were not sufficiently supported to warrant the withholding.

Deficiencies in Manually Recording Taxable Travel Transactions

During the course of reviewing judgmentally selected samples of employee long-term taxable travel vouchers, we identified various instances where AFS/TRAS input errors occurred due to manually entering the transactions, including:

- Thirteen instances where the beginning travel dates were after the ending travel dates.
- Eight instances where state taxes were not consistently withheld, resulting in a possible under withholding of $595.
- One instance where an incorrect tax code was entered, resulting in an overstatement of federal wages of $13.
- A duplicate travel payment of $3,045 that was not identified by the system, but was subsequently reported and repaid by the receiving employee.[5]

At the time of our review, the extent to which the IRS updated its TRAS involved only the identification by the reporting employee that taxable travel was being reported. The process of establishing taxable income and withholding taxes remained a manual system.

Entering incorrect information that affects an employee's tax obligations could possibly cause the employee to not timely satisfy his/her tax liability. Since employees are reimbursed through the ITRA program for taxes withheld, the IRS could incur expenses associated with over-

[5] The original TRAS voucher was received in the BFC on May 4, 2000. A duplicate manual voucher was received in the BFC on May 15, 2000. We did not determine the reasons for the second submission, but will consider this issue for future audit work.

withholding. Also, the duplicate payment of a travel voucher, if not identified and returned by the receiving employee, would represent an unauthorized disbursement.

Recommendation

1. The IRS CFO should consider automating the long-term travel withholding process, including validity checks, as much as possible, given the types of manual errors identified during this audit.

Management's Response: The IRS has updated the TRAS to perform the long-term taxable travel withholding process. The automated process includes systemic controls to ensure the computations and amounts are correct.

No State Income Taxes Withheld on Adjusting Entries

The BFC was not calculating and withholding state income taxes associated with AFS adjusting entries to correct previously recorded non-taxable travel transactions. We identified 16 adjustment entries included in our judgmental samples,[6] totaling approximately $27,600 in taxable income, for which no withholding was made for state income taxes. These adjustment entries did, however, include withholding for Federal income, FICA, and Medicare taxes.

The BFC did not withhold state taxes because the IRS' guidelines for correcting vouchers processed as regular travel that should have been long-term taxable travel state that, "Travelers should be informed that there will not be any state taxes withheld for these vouchers." IRS staff informed us that this practice exists because corrected travel vouchers may involve prior tax years and the current state tax withholding may have changed. Since withholding amounts are calculated for other applicable taxes, we believe this practice is inconsistent in that the same standard should apply to all tax withholding.

Though the amounts associated with the state income tax withholdings may not be individually significant, not

[6] Seven of the entries came from our sample of 25 high dollar/volume transactions, and 9 came from our sample of 25 low dollar/volume transactions.

withholding applicable state income taxes could impact an employee's ability to meet state income tax obligations.

Recommendation

2. The IRS CFO should reconsider its guidelines not to withhold state income taxes associated with long-term taxable travel adjustment entries, making them consistent with Federal income, FICA, and Medicare tax withholding practices.

Management's Response: The IRS will evaluate this recommendation and make any necessary changes to enhance the accuracy of adjusting entries.

No Supervisory Approval for Adjusting Entries

Our review of a judgmentally selected sample of 25 adjusting entries during CY 2000 showed that 10 were processed by the BFC without supervisory approval. These adjustment requests were received and processed based on e-mails and memorandums received directly from the requesting employees. The BFC, in an effort to be timely, processed the requests without assuring that they were approved by the traveler's supervisor.

The Long-Term Taxable Travel guidelines require that requests for adjustments to previously recorded travel reimbursement transactions be sent through the employee's supervisor for approval.

Without supervisory approval, unsubstantiated requests for adjustments may not be identified, especially when the adjustment is from a taxable travel status to a non-taxable status.

Recommendation

3. The IRS CFO should re-emphasize existing approval procedures associated with long-term taxable travel adjustments. Further, BFC managers should instruct their staff to reject all requests for long-term taxable travel adjustments that are not approved by the employees' supervisor.

Management's Response: The Beckley Finance Center staff implemented a requirement, in February 2001, to reject requests for long-term taxable travel adjustments that do not reflect supervisory approval.

Office of Audit Comment: We confirmed with Beckley Finance Center management that the implementation of this requirement was in the form of an oral directive during a staff meeting, and that written procedures were not prepared to reinforce the oral directive.

Misclassification of Travel Vouchers

Our review of a judgmentally selected sample of 25 employees involving 34 low dollar/low volume long-term taxable travel vouchers processed during CY 2000 showed 22 vouchers that did not support a long-term taxable situation. These vouchers included $1,531 in taxable income, $718 in Federal taxes withheld, $55 in state income taxes withheld, $37 in Medicare Taxes withheld, and $45 in FICA taxes withheld. Most instances involved only one voucher for one month's travel, or one adjusting entry for one to three months' travel. Available Forms 12654 did not indicate travel of a nature that would be defined as long-term taxable travel. Further, some local travel, though performed in the same area, was to different locations.

Our review of a judgmentally selected sample of 10 employees involving 145 high dollar/high volume non-long-term taxable travel vouchers processed during CY 2000 showed 1 employee who filed 13 vouchers that appeared to support a long-term taxable situation. These vouchers totaled $16,753 and indicated regular mileage reimbursement for a 13-month period.

Incorrectly classifying regular travel as long-term taxable travel and processing the associated tax withholding causes employees to over pay FICA and Medicare taxes. Further, it causes the IRS to over-reimburse the employees for Federal and state income taxes associated with the ITRA program. Also, not classifying long-term travel accurately violates established tax reporting requirements.

Recommendation

4. The IRS CFO should re-emphasize existing procedures associated with the classification of long-term taxable travel situations, to ensure that all employees and

managers are thoroughly familiar with long-term taxable requirements. The CFO should also consider using data analysis techniques, similar to the tests we performed, periodically to identify and correct potential misclassification of travel situations.

Management's Response: The IRS has issued policies and procedures for long-term taxable travel and made them available on the CFO travel and relocation website. The CFO will issue a memorandum to all Heads of Office re-emphasizing the policies and procedures associated with the classification of long-term taxable travel situations, and asking them to ensure all employees and managers are thoroughly familiar with long-term taxable travel requirements.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the Internal Revenue Service (IRS) had developed and implemented effective procedures and system corrections necessary to address long-term taxable travel reporting requirements. To accomplish our objective, we:

I. Developed an understanding of the long-term taxable travel recording process and related internal controls.

  A. Interviewed key Chief Financial Officer personnel familiar with long-term taxable travel recording to document the overall taxable travel recording operation.

  B. Researched the laws and regulations associated with long-term taxable travel.

  C. Obtained related correspondence, internal guidelines, web page announcements and memos (general and targeted), which were prepared by the IRS explaining the requirements of reporting long-term taxable travel.

  D. Prepared a narrative overview of the long-term taxable travel recording operation, including associated risk if procedures are not established or followed.

  E. Identified IRS processes/controls in place to ensure compliance with long-term taxable travel requirements.

  F. Compared laws and regulations to IRS' operation as documented in the cycle memo to ensure consistency.

II. Determined whether IRS implementation personnel are knowledgeable of long-term taxable travel requirements.

  A. Interviewed IRS functional implementation personnel regarding their responsibilities associated with long-term taxable travel recorded on the Travel Reimbursement Accounting System (TRAS).

  B. Compared their responses for consistency with established requirements.

III. Determined whether the TRAS was updated with long-term taxable travel requirements on a timely basis.

  A. Obtained TRAS related updates.

  B. Compared those updates to what is maintained on the system, and to established requirements.

IV. Determined whether long-term taxable travel expenses were accurately recorded and associated Forms W-2, *Wage and Tax Statement* withholding was accurately calculated.

A. Obtained an Automated Financial System (AFS) file of long-term taxable travel recorded by IRS employees for the period January 1, 2000 to December 31, 2000. This file also contains Form W-2 information.

B. Judgmentally selected a sample of long-term taxable travel vouchers obtained in step A and recalculated the withholding amounts manually assigned by the IRS' Beckley Finance Center (BFC) for accuracy.

<u>SAMPLE BASIS:</u>

From the IRS-prepared database of 1,702 employees that reported long-term taxable travel on 10,292 vouchers in calendar year 2000, we judgmentally selected 25 employees based on a combination of a high number of vouchers filed (most averaged 8 vouchers during the year; 9 had less than 5) and a high dollar value (over $6,000 in the aggregate). This sample of 25 employees filed a total of 181 travel vouchers.

From this same database, we also judgmentally selected 25 employees based on a combination of a low number of vouchers filed (no more than 3) and a low dollar value (under $300 in the aggregate). This sample of 25 employees filed a total of 34 travel vouchers.

From this same database, we also judgmentally selected 25 employees that filed vouchers we considered unusual due to the reported beginning travel date being after the ending date, or the reported beginning travel date being prior to 1999.

C. Judgmentally selected a sample of Form W-2 information obtained in step A and verified in detail the accuracy of the long-term taxable travel reported using the employees' travel vouchers and travel patterns (See above for sampling basis).

D. Obtained a file of long-term taxable travel adjustments entered into the AFS from January 1, 2000 to December 31, 2000, to identify the extent to which these adjustments were being made.

E. Judgmentally selected a sample of BFC adjustments obtained in step D and verified the accuracy of the adjustments using the employees' travel vouchers, travel patterns, and any documentation to substantiate the adjustment.

<u>SAMPLE BASIS:</u>

From an IRS-prepared listing of 3,812 long-term taxable travel adjustments in calendar year 2000, we randomly selected a sample of 25 adjustments.

V. Determined whether any long-term taxable travel was performed that was not recorded and reported in accordance with regulations.

A. Obtained a file of non-long-term taxable travel recorded by IRS employees for tax year 2000.

B. Reviewed the file obtained in step A to identify any indicators of long-term taxable travel, i.e. high volume of high value travel vouchers, consistent monthly claims of mileage, etc.

C. Judgmentally selected a sample of travel vouchers by employee obtained in step A to identify any non-compliance with reporting requirements.

<u>SAMPLE BASIS:</u>

From the IRS-prepared database of 52,658 employees that reported no long-term taxable travel in calendar year 2000, we judgmentally selected 10 of 1,981 employees based on a combination of a high number of vouchers filed (15 or more), a high dollar value (over $5,000 in the aggregate), and the availability of records. We reviewed 145 available travel vouchers of the 181 filed by these 10 employees.

Appendix II

Major Contributors to This Report

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Appendix III

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Appendix IV

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

CHIEF FINANCIAL OFFICER

RECEIVED
MAY 24 2002

May 24, 2002

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

FROM: W. Todd Grams
Chief Financial Officer

SUBJECT: Draft Audit Report - Controls Need To Be Strengthened Over the Internal Revenue Service's Taxable Travel Reporting (Audit # 200110027)

I am responding to your memorandum concerning the recent review of long-term taxable travel reporting requirements, which your office conducted at our request. The audit identified four recommendations. We agree with Recommendations 1, 3, and 4, and either have completed or will complete implementation of corrective action plans by October 2002. We are evaluating Recommendation 2 and will make a decision before the end of this fiscal year on whether we wish to change our current policy. Specific responses to your recommendations are attached.

If you have any questions, please contact me at 202.622.6400, or a member of your staff may contact Angela Cook, Chief, Office of Travel Management and Relocation, at 301.492.5606.

Attachment

Responses to Draft Audit Report Recommendations
Audit # 200110027

IDENTITY OF RECOMMENDATION 1: The IRS' CFO should consider automating the long-term travel withholding process, including validity checks, as much as possible, given the types of manual errors identified during this audit.

ASSESSMENT OF CAUSE(S): The following are reasons for errors related to long-term taxable travel:

- Thirteen instances occurred because the Beckley Finance Center (BFC) made data entry errors. These data input errors had no effect on the accuracy of the ITRA calculation, tax withholdings, or W-2 reporting.
- Eight instances occurred because employees incorrectly loaded the original amounts for state tax rates into the software program, and later corrected them without going back to previously processed cases.
- Seventeen instances occurred because travelers reported changes or corrections to vouchers after the cut-off date.
- One duplicate travel payment occurred because the traveler returned it before BFC could work the automated report TA-05, Duplicate Travel Voucher/Date Report, generated by the Automated Financial System (AFS). BFC would have identified this error and ensured employees made the required correction.

CORRECTIVE ACTION: We have updated the IRS Travel Reimbursement and Accounting System (TRAS) to perform the long-term taxable travel withholding process. The automated process includes systemic controls to ensure the computations and amounts are correct. No further action is necessary.

IMPLEMENTATION DATE: Completed March 18, 2002.

RESPONSIBLE OFFICIAL: Director, Administrative Accounting

CORRECTIVE ACTION MONITORING PLAN: We will process vouchers that contain Long-Term Taxable Travel (LTTT) on TRAS and send them directly to the accounting system for immediate payment. TRAS will withhold Federal income tax, state income tax (if appropriate), Medicare, and FICA (if appropriate). TRAS will also compute the Withholding Tax Allowance (WTA) and give the traveler credit for it. The system will prompt the traveler for the LTTT authorization number during voucher input. It will also display all of the withholding computations and the WTA during the TRAS signature, review, and approval processes.

IDENTITY OF RECOMMENDATION 2: The IRS' CFO should reconsider its guidelines not to withhold state income taxes associated with long-term taxable travel adjustment entries, making them consistent with Federal income, FICA, and Medicare tax withholding practices.

ASSESSMENT OF CAUSE: Management made a decision that affected employees should report the state income taxes on their state return. The IRS decided to withhold only the Federal taxes on the employees' behalf.

CORRECTIVE ACTION : We will evaluate this recommendation and make any necessary changes to enhance the accuracy of adjusting entries.

IMPLEMENTATION DATE : Proposed October 1, 2002.

RESPONSIBLE OFFICIAL: Director, Administrative Accounting

CORRECTIVE ACTION MONITORING PLAN: We will form a task group to explore the process and develop revised guidelines for long-term taxable travel adjusting entries

IDENTITY OF RECOMMENDATION 3: The IRS' CFO should re-emphasize existing approval procedures associated with long-term taxable travel adjustments. Further, BFC managers should instruct their staff to reject all requests for LTTT adjustments that are not approved by the employees' supervisor.

ASSESSMENT OF CAUSE: The lack supervisory approval for certain adjusting entries was the result of management and employees' struggling to understand the tax implications of LTTT. As the end of the calendar year approached, employees began submitting changes. BFC was overwhelmed with changes and pressured to complete changes by end of the year. Therefore, verification of supervisory approval was not completed in all instances.

CORRECTIVE ACTION: BFC identified this problem and implemented the requirement, in February 2001, to reject requests for LTTT adjustments that do not reflect supervisory approval. No further action is necessary.

IMPLEMENTATION DATE: Completed February 2001.

RESPONSIBLE OFFICIAL: Director, Beckley Finance Center

CORRECTIVE ACTION MONITORTING PLAN: We have implemented the following process:

- If the request is to amend only one voucher from taxable to non-taxable and WebTRAS/AFS identifies no other LTTT vouchers, we will process the request without management concurrence since we consider it to be a data input error (mis-coding) on the part of the traveler.
- If the request affects more than one voucher, we will require management concurrence.
- If the request affects a prior year W-2, we will require management concurrence.

IDENTITY OF RECOMMENDATION 4: The IRS' CFO should re-emphasize existing procedures associated with the classification of long-term taxable travel situations, to ensure that all employees and managers are thoroughly familiar with long-term taxable requirements. The CFO should also consider using data analysis techniques, similar to the tests we performed, periodically to identify and correct potential misclassification of travel situations.

ASSESSMENT OF CAUSE: Calendar year 2000 was our first full year in accounting for LTTT expenses. We did not formally issue guidance on what expenses were taxable until the second half of the year.

CORRECTIVE ACTION : We have issued policies and procedures for LTTT and made them available on the CFO travel and relocation website. The CFO will issue a memorandum to all Heads of Office re-emphasizing the policies and procedures associated with the classification of LTTT situations, and asking them to ensure all employees and managers are thoroughly familiar with LTTT requirements.

IMPLEMENTATION DATE: Proposed October 1, 2002

RESPONSIBLE OFFICIAL: Director, Administrative Accounting

CORRECTIVE ACTION MONITORING PLAN: The CFO will work with Agency Wide Shared Services to train Travel Security Administrators (TSAs) to respond to manager/employee questions on LTTT procedures. The CFO will also develop data analysis techniques and management reports to identify misclassification of travel situations.